

**Statement of The Honorable Christopher B. Burnham
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and
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United States Department of State**

**Before the
Subcommittee on Government Management, Finance and
Accountability
Committee on Government Reform
United States House of Representatives**

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**“Changes to OMB Circular A-123,
Management’s Responsibility for Internal Control”**

Thank you, Mr. Chairman, for the opportunity to appear before the Subcommittee today to discuss recent changes to the Office of Management and Budget’s (OMB) Circular A-123, *Management’s Responsibility for Internal Control*. I am providing my views on this subject from my perspective as both a member of the Chief Financial Officers’ (CFO) Council and as the CFO of the United States Department of State. The CFO Council and Department of State fully support the revised Circular and commend this Subcommittee for its efforts to promote and strengthen internal control throughout the Federal Government in a thoughtful and progressive manner. We also applaud the work of the Office of Management and Budget (OMB) and the President’s Council on Integrity and Efficiency (PCIE) to recognize and build upon the existing Federal internal control framework in an effort to strengthen and improve such controls through the revised Circular A-123.

Some of the nation’s most dramatic business failures – notably Enron and WorldCom -- occurred in the early 2000’s. These failures resulted in the passage of the Sarbanes-Oxley Act of 2002, which has led to sweeping changes in corporate accountability and the auditing profession. In light of these developments and recent legislation requiring the Department of Homeland Security to adopt practices similar to those

imposed under the Sarbanes-Oxley Act, a reassessment of the existing internal control requirements for Federal agencies was begun in 2003. Fortunately, we have a solid foundation for internal control in the Federal Government resulting principally from the implementation of the Federal Managers' Financial Integrity Act (FMFIA) over the past two decades. It is against this contextual backdrop that the recent revisions to OMB Circular A-123 were developed.

Revisions to OMB Circular A-123

The Federal Government often lags behind the private sector in many areas but not when it comes to internal control. In large part due to FMFIA, the Federal Government has been required for more than two decades to establish and maintain an internal control structure that not only covers financial reporting but also spans across the full range of a Federal agency's programs and activities. FMFIA also requires that the head of the agency, based on an evaluation, provide an annual statement of assurance to the President and Congress on whether the agency has met this requirement.

Background

OMB Circular A-123 was first issued in the 1980's to provide guidance to Executive departments and agencies on implementing the FMFIA. Several revisions have been made to the Circular since the early 1980's to reflect the evolving nature and our improved understanding of internal controls during this time period. In the last two decades, much has been learned about the critical role internal controls play in organizations of any size.

Since the early 1980's, certain basic internal control tenets have evolved. What's clear now is that *every* entity – regardless of its purpose, size, form of ownership, or organizational structure – must have effective internal controls to carry out its mission. The responsibility for establishing and maintaining those controls rests squarely on the shoulders of management. To advance a common understanding of internal control, a conceptual framework, consistent definitions and terminology, and criteria for evaluating controls is needed to focus the efforts of internal control stakeholders such as entity managers, auditors, legislators, regulators, citizens, and academics. Internal control must be established, documented, evaluated, and monitored in every entity.

The Commission of Sponsoring Organizations of the Treadway Commission (COSO) is a leader in researching, developing, and promoting sound internal controls. COSO is an independent private sector initiative that studies the causes of fraudulent financial reporting and provides recommendations for preventing such occurrences by improving business ethics, internal controls, and corporate governance. In 1992, COSO published an integrated framework for internal control that is widely accepted and adopted throughout the private and public sectors today. This framework provides a conceptually sound and practical approach to establishing and evaluating internal controls.

Joint CFO Council and PCIE Efforts

Under the direction of OMB, in 2003 the CFO Council and PCIE formed a joint committee to evaluate the adequacy of internal control requirements in the Federal Government. This joint committee, comprised of representatives from the CFO and Inspector General (IG) communities, was tasked with reviewing the new internal control assurance requirements applicable to the private sector for their relevance to Federal agencies and developing new policies for internal control in the Federal Government, as considered necessary. The recommendations resulting from the joint committee's work formed the basis for the policy changes imbedded in the revised Circular A-123. The CFO Council also plans to work with OMB to develop an implementation guide and training for Federal agencies.

Mr. Chairman, I believe that this joint committee is an excellent example of how the CFO and IG communities can work together in a collaborative, professional manner to advance the public good. This model has been used successfully to facilitate the implementation of other important initiatives such as the Improper Payments Information Act of 2002. We are grateful to our colleagues in the IG community for the professional competence, technical skills, and business acumen they bring to bear on assessing internal control policies in the Federal environment. We look forward to working with them as we address the many challenges ahead.

Key Provisions of the Revised Circular A-123

The revised Circular reaffirms management's responsibility for internal control in Federal programs and operations, and provides explicit guidance for management to use in carrying out its charge to establish, assess,

strengthen, and report on internal control. The revised Circular calls for Federal agencies to deploy systematic and proactive measures to:

- Develop and implement appropriate, cost-effective internal control for results-oriented management;
- Assess the adequacy of internal control in Federal programs and operations;
- Separately assess and document internal control over financial reporting;
- Identify needed improvements;
- Take corresponding corrective action; and
- Report annually on internal control through management assurance statements included in the PAR.

The revised Circular builds off of the fundamental principles underlying its predecessor (i.e., Circular A-123, revised June 21, 1995) to advance internal control to a new level within the Federal Government. In addition to providing more comprehensive and detailed internal control guidance to Federal managers, the revised Circular also includes the following significant changes.

- **Strengthens the Requirements for Assessing the Effectiveness of Internal Control over Financial Reporting** – This area is viewed by many in the Federal financial management community as the most significant change imposed by the revised Circular. Appendix A of the Circular provides new specific requirements for conducting and documenting management’s assessment of the effectiveness of internal control over financial reporting, including a separate annual assurance on internal control over financial reporting. These new requirements are similar to those imposed by the Sarbanes-Oxley Act for the management of publicly-traded entities to assess, document, and report on the effectiveness of internal control over financial reporting.
- **Integrates Agency Internal Control Activities** – The revised Circular emphasizes the need for agencies to consider, coordinate, and integrate other internal activities – many of which are required by statute -- that contribute to internal control. For instance, the Improper Payments Information Act of 2002 requires agencies to determine which Federal programs are susceptible to improper payments, test high-risk programs, report the results in agency PARs, and determine the underlying cause for

improper payments. This process will contribute to and strengthen an agency's internal control infrastructure. The revised Circular A-123 serves as the internal control umbrella under which other agency activities should be integrated to support management's assertion about the effectiveness of internal control more broadly.

- **Incorporates COSO Framework** – The revised Circular reflects currently accepted standards, objectives, and terminology for internal control based on the COSO framework and its five interrelated components: control environment, risk assessment, control activities, information and communication, and monitoring.
- **Encourages Use of Senior Management Councils and Senior Assessment Teams** – The Circular recognizes the important role of senior management councils in Federal agencies to oversee the internal control program throughout the entity. The Circular also recommends the use of senior assessment teams, as a subset of the senior management council, to drive management's assessment of internal control over financial reporting.
- **Creates Reportable Condition Category under FMFIA** – The revised Circular defines control deficiencies and introduces the concept of reportable conditions under FMFIA reporting. This category is important because it must be tracked and monitored internally, which will help to resolve reportable conditions before they become material weaknesses.
- **Authorizes OMB to Require an Audit Opinion Selectively** – While a separate audit opinion on internal control over financial reporting is not required by the Circular, OMB may, at its discretion, require an agency to obtain such an opinion. This provision would be used in situations where an agency continuously falls behind in correcting its deficiencies.
- **Requires Service Organizations to Provide Assurances** -- The revised Circular calls for management of cross-servicing agencies to provide an annual assurance statement, based on testing, to their customer agencies.

The CFO Council fully supports the changes to Circular A-123. Each of the significant changes makes sense in the Federal environment and should lead

to greater accountability for Federal programs and operations, including financial reporting.

Impact of Revised Circular on Federal Financial Management

Internal control is central to fulfilling our responsibility for accountability over taxpayer funds. We have recently witnessed in the private sector the catastrophic results that failures in internal control can trigger.

Unfortunately, internal control is far from the most exciting subject to debate, and it usually takes a high-profile breakdown in controls for people to even notice them. Also, because internal controls focus on prevention, it is often very difficult to quantify the impact of improved controls. For instance, how do you measure the impact of fraud that was prevented, or the increase in public confidence that results from stronger control?

Despite these difficulties, the current increased attention on internal control is well-placed. After two decades of implementing FMFIA, we understand what our counterparts in the private sector now appreciate – that internal control is integral to every part of an organization’s infrastructure rather than an isolated management tool. In the end, stronger controls yield beneficial dividends – even though they are difficult to measure.

For all Federal agencies, implementing the revised Circular provides a valuable opportunity to reassess the effectiveness of their overall internal control structure. The level of effort required depends in large part on the degree to which an agency fully implemented the previous version of Circular A-123, dated June 21, 1995. Today, the implementation of FMFIA varies among Federal agencies – some have rigorous FMFIA programs that allow their agency heads to provide “unqualified” annual assurances about their controls while others do not. These mixed results, will directly impact the level of effort and resources required to successfully implement the overall internal control requirements of the revised Circular across Federal agencies. Some agencies such as the State Department will only need to modify slightly their existing management control programs. Others may need to overhaul and document their management controls. It is interesting to note that with respect to an entity’s overall internal control structure (formerly known as “management controls”), the Federal Government’s pre-existing requirement for annual assurance statements by agency heads exceeds management’s requirements for publicly-traded companies under the Sarbanes-Oxley Act.

It is too soon to reasonably determine the impact across agencies of implementing Appendix A of the revised Circular, which imposes new specific requirements for conducting management's assessment of the effectiveness of internal control over financial reporting. Arguably, Federal agencies should have been documenting and assessing internal controls over financial reporting as part of FMFIA. However, since the requirements of Appendix A are more rigorous and prescriptive than the pre-existing requirements, it is unlikely that many Federal agencies would meet these new requirements today. Most agencies will need to expand documentation and enhance assessments of internal control over financial reporting. While we can and will learn from the private sector experience implementing similar requirements under the Sarbanes-Oxley Act, it will take additional time to understand the incremental impact of implementing Appendix A in Federal agencies.

Importance of Controls at Department of State

At the Department of State, we take our statutory responsibility under FMFIA very seriously. We have developed a robust management control structure that has been recognized as a best practice by OMB and enabled the Secretary of State to provide an unqualified (or "clean") assurance statement for 2003 and 2004. As a result, we are now well-positioned to implement the revised Circular A-123 – not just the letter of the revised Circular but also the spirit and intent of this Administration to strengthen stewardship over taxpayer funds that underpin the revised Circular.

A strong management control structure is essential for an organization such as the State Department, which functions in an extremely challenging and complex environment. The Department operates about 260 embassies and consulates located in more than 170 countries throughout the world as well as our domestic operations. We conduct business transactions in over 150 currencies and even more languages and cultures. We provide the administrative operating platform for about 45 other U.S. Government organizations overseas and pay 64,000 persons each pay period on behalf of the Department and other serviced agencies. In short, no corporation or other Federal agency has the depth and variety of challenges faced daily by our team in support of the Department's mission to create a more secure, democratic, and prosperous world for the benefit of the American people and international community.

While we have a proud tradition of embracing both the concepts and practical application of controls throughout the State Department, we welcome the opportunity to strengthen them further as called for under the revised Circular. We recognize that robust controls are essential to managing our day-to-day activities and programs and they position us to face with confidence the many challenges that lay ahead as we carry out the Department's foreign policy mission.

Strong Controls Contribute to Our Success

The Department's management control program provides a solid foundation for moving beyond mere compliance with laws and regulations towards achieving world-class excellence in managing Federal programs and operations. Our sustained focus over the years on strengthening management control has served as a catalyst for positive change within the Department, resulting in the reduction of FMFIA material weaknesses from 10 in FY 1999 to zero by the end of FY 2002. In addition, for the first time in 2003, and again in 2004, the Department's independent auditors reported no material weaknesses in internal control. Our rigorous management control program has also led the way for the following significant accomplishments:

- **President's Management Agenda Scorecard** – In January 2005, OMB identified State, along with three other Federal agencies (Energy, Labor, and the Social Security Administration), as the most successful at implementing the management disciplines that underpin the *President's Management Agenda (PMA)*. The Department has “double greens” for status and progress in implementing the PMA in the following areas: human capital, financial performance, E-Gov, and budget and performance integration.
- **President's Quality Award** – In December 2004, the Department received the President's Quality Award for its innovation in integrating OMB's Program Assessment Rating Tool (PART) into the Department's overall strategic and performance management processes, and for having some of the highest PART scores government-wide. This prestigious award is the highest recognition given by the Federal Government for managerial excellence.

- **Accelerated Reporting** – We completed our 2004 Performance and Accountability Report (PAR) by November 15, 2004 – a feat unimaginable just a few years ago. When I joined the Department in 2002, it took about five months after year-end to complete the annual financial statement audit, as compared to just 45 days for FY 2004. Meeting this goal for the first time in 2004 is particularly noteworthy in light of our competing priorities to support our mission in Iraq and successfully relocate our global financial operations to Charleston, SC.
- **Financial Accountability** – For the eighth consecutive year, we received an unqualified (or “clean”) audit opinion on the Department’s 2004 financial statements, which was especially challenging under the accelerated reporting date of November 15. Only a handful of Federal agencies can tout such a long-running accomplishment.
- **Award-Winning Reports** -- For the third year in a row, the Department’s FY 2003 PAR received the most prestigious award in Federal financial reporting, AGA’s *Certificate of Excellence in Accountability Reporting*. State is one of only four cabinet-level agencies to receive this award for FY 2003. Also, for the second year, the League of American Communications Professionals selected the Department’s 2003 *PAR Highlights* report as one of the best 100 annual reports in America and placed it first among government reports.

None of these successes would have been possible without a sound management control structure that permeates our organization – from the tone set by top management to the manner in which transactions are processed on a daily basis, and every step in between.

Our Current Control Program: *A Best Practice*

Each year under FMFIA, the Department evaluates its management control systems. These evaluations provide reasonable assurance about whether the objectives of FMFIA are achieved and form the basis for the Secretary’s annual statement of assurance. Exhibit 1 depicts our current FMFIA annual assurance process.

The Department’s management control program is overseen by the Management Control Steering Committee (MCSC), which I chair as the Assistant Secretary for Resource Management and Chief Financial Officer.

The MCSC also includes nine other Assistant Secretaries [including the Chief Information Officer and the Inspector General (non-voting)], the Deputy Chief Financial Officer, and the Deputy Legal Adviser. State's Office of Inspector General has served an important role as a collaborative partner with management through the MCSC, and adds value to the entire process.

Individual assurance statements from Ambassadors assigned overseas and Assistant Secretaries in Washington, D.C. serve as the primary basis for the Department's assurance that management controls are adequate. Individual assurance statements are based on information gathered from various sources including the managers' personal knowledge of day-to-day operations and existing controls, management program reviews, and other management-initiated evaluations. In addition, the Office of Inspector General and the Government Accountability Office conduct periodic reviews, audits, inspections, and investigations of the Department's programs and activities.

To be considered a material weakness for FMFIA reporting purposes, the problem should be significant enough that it meets one or more of the following criteria.

- Significantly impairs the fulfillment of the Department's mission.
- Deprives the public of needed services.
- Significantly weakens established safeguards against waste, loss, unauthorized use or misappropriation of funds, property, other assets, or conflicts of interest.
- Merits the attention of the Secretary, the President, or a relevant Congressional oversight committee.
- Is of a nature that omission from the report could reflect adversely on the Department's management integrity.

During the last five years, the Department made significant progress by correcting each of its outstanding material weaknesses. In addition, there are no items specific to the Department on the Government Accountability Office's High Risk List, and there have not been any since 1995. Exhibit 2 shows the Department's progress correcting and closing material weaknesses.

In fiscal year 2002, the Department added the category of “reportable condition” to our program, which is now included in the revised Circular. Reportable conditions are less significant control matters that do not need to be reported under FMFIA but warrant MCSC monitoring and internal tracking. By introducing the reportable condition category of control weakness, the Department moved beyond merely fixing material weaknesses to actively identifying and preventing them.

Implementing the Revised Circular: A “Green” Agency’s Perspective

Building off of our successful FMFIA program and in the spirit of continuous improvement, we look forward to fully implementing the revised Circular. This provides us with the opportunity to take a fresh look at the effectiveness of our overall internal control program in today’s environment.

While we expect to identify and implement certain improvements to our overall program, we do not expect wholesale changes. For instance, we envision a broader and more active role for our Management Control Steering Committee, particularly as it relates to internal control over financial reporting and the consideration of fraud within the Department (relating to Statement on Auditing Standards 99, *Consideration of Fraud in a Financial Statement Audit*). The MCSC will also play a key role in integrating other activities within the Department that contribute to our internal control structure. As mentioned previously, we already identify and track reportable conditions through the MCSC, so implementing this aspect of the revised Circular will not cause us additional effort. We intend to fully adopt COSO’s integrated framework for internal control, which will prompt revisions to our current FMFIA annual assurance process and related risk assessment tools. Of course, training would need to be provided at all levels of the Department to explain our enhanced internal control program and how each employee contributes to that program.

Most of the changes to our overall control program will be implemented by State Department employees in the normal course of performing their daily activities, though some contractor support is planned. We are currently trying to determine whether our existing documentation of management control processes meets the requirements of the revised Circular. For instance, a starting point for us is to determine whether the documents produced in connection with our efforts to adopt the International Organization of Standardization’s ISO 9000 quality management standards

would meet the requirements of revised Circular. Should we discover documentation gaps, there will be resource implications.

The requirements of Appendix A present the most significant challenge to us. While we have extensive documentation of certain financial reporting processes and controls, we do not believe that the documentation is sufficiently comprehensive to fully satisfy the Circular's requirements. This is another area in which we are actively trying to determine the resource implications of fully implementing the revised Circular. As both a cross-servicing agency and a customer of other Federal service organizations, we are assessing the impact of the new requirement for service organizations to provide annual assurance statements, based on control testing, to their customers. We are using a contractor skilled in audit techniques to assist us in implementing the requirements of Appendix A.

We expect to incur one-time cost increases in 2005 and 2006 as we concentrate on first-time documentation and assessment efforts. We anticipate these costs dropping off and stabilizing for 2007 and beyond. It is too soon to quantify the impact of fully implementing the revised Circular. Once we comply with Appendix A, we expect our financial statement auditors to use management's work as a starting point for conducting the audit, which may yield some audit savings.

We view this revised Circular as an important means of appropriately managing the risk associated with Federal programs and activities to discharge our responsibilities as stewards of public funds. As a "green" agency, we will not rest on our accomplishments. As contemplated under the PMA Scorecard, we are continuously seeking to improve further our management of the State Department. The revised Circular provides us with the framework and tools needed to make significant advancements to our internal control infrastructure.

Conclusion

The CFO community appreciates the opportunity to implement the important policies included in the revised Circular A-123 in a systematic and orderly fashion. It is critical for management to understand, document, and assess its internal control over financial reporting to attain stewardship over taxpayer funds. We believe that the Circular, when fully implemented, will drive further improvements in the accuracy and timeliness of Federal

financial reporting. We also believe that the revised Circular will cause agencies, such as the State Department, to re-examine existing control programs to identify opportunities to strengthen controls over the entire portfolio of Federal programs and operations.

Thank you, Mr. Chairman, for allowing me to share my views on OMB's revised Circular A-123. My colleagues in the CFO Council and I appreciate your leadership and the Committee's on this and other Federal financial management initiatives. I look forward to answering any questions you may have.

Exhibit 1: State's FMFIA Annual Assurance Process

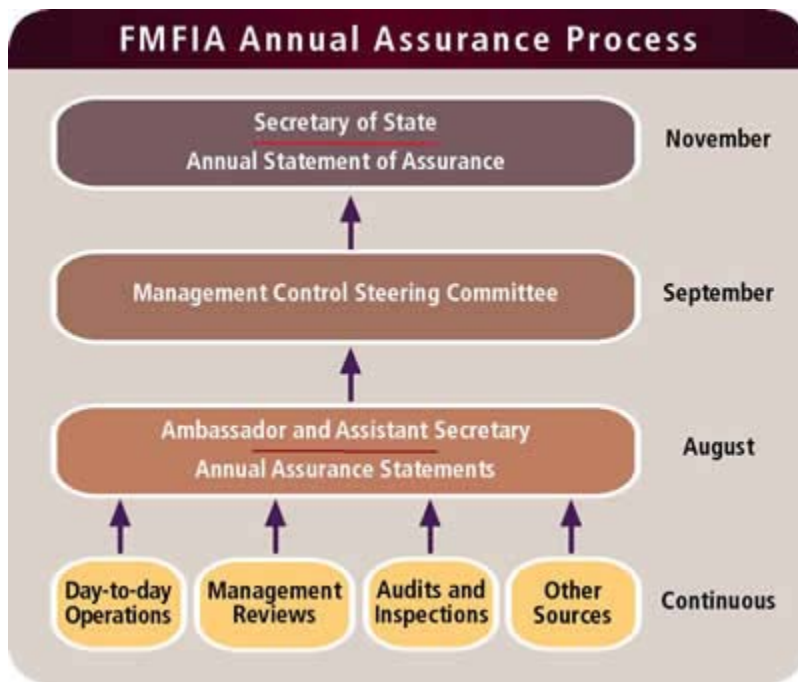


Exhibit 2: State's Material Weaknesses (FY 2000 through 2004)

MATERIAL WEAKNESSES BY FISCAL YEAR				
Fiscal Year	Number at Beginning of Fiscal Year	Number Corrected	Number Added	Number Remaining at End of Fiscal Year
1999	10	7	0	3
2000	3	2	2 ¹	3
2001	3	0	0	3
2002	3	3	0	0
2003	0	0	0	0
2004	0	0	0	0
Note 1: Reported by State as a result of the merger with the United States Information Agency.				

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Cleared: D:EYoung (ok)
 P:MWong (ok)
 S/P:EGreen (ok)
 M:SFeeley (ok)
 M/P:DWertman (ok)
 RM/DCFO:CFlaggs (ok)
 RM/CFO:CScalzo (ok)
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